NOT TO BE PUBLISHED IN THE OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION SEVEN

FRED and JOYCE HAMEETMAN, Plaintiffs and Appellants, v. CALIFORNIA FRANCHISE TAX BOARD, Defendant and Respondent.	B187278 (Los Angeles County Super. Ct. No. BC 305968)

APPEAL from a judgment of the Superior Court of Los Angeles County. Mary Ann Murphy, Judge. Affirmed.

Gibbs, Giden, Locher & Turner and Eric L. Troff for Plaintiffs and Appellants.

Bill Lockyer, Attorney General, W. Dean Freeman, Lead Supervising Deputy Attorney General, and Donald R. Currier, Deputy Attorney General, for Defendant and Respondent.

Plaintiffs Fred and Joyce Hameetman[1] appeal from the judgment in favor of defendant California Franchise Tax Board ("FTB") in their action for a tax refund. Plaintiffs contend they were entitled to a deduction for a bad business debt based on money Joyce advanced to her limited partnership for loan to a third party because the intent of the parties was the transaction was to be a loan from her to the third party. We affirm.

FACTUAL AND PROCEDURAL SYNOPSIS

In 1984, Joyce and Fred were limited partners owning 99 percent of Muir Partners ("Partnership"), a California limited partnership. The remaining one percent was owned by Cal American Management Corporation ("Cal American"), a California corporation, which was the general partner of the Partnership. Cal American was owned entirely by Fred.

The business of the Partnership was "to purchase, hold, develop, improve, lease, hypothecate and/or sell" an apartment building (the "Property") located in San Francisco. The Property was the only asset of the Partnership.

The Property had been purchased from Traweek Investment Fund #10 (the "Fund") by Cal American in 1984.[2] The managing partner of the Fund was Richard Traweek, who held a 20 percent interest in the Fund. The Property was purchased for $38,000,000, consisting of an all inclusive note which contained three separate notes for: (1) $19.2 million, (2) $5,802,750, which represented the existing indebtedness of the seller and which was secured by first and second trust deeds; and (3) $13 million, which

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[1] When necessary to identify an individual appellant, he or she is referred to by his or her first name.

[2] The stipulated facts stated the Property was purchased by Cal American; in Joyce's declaration, she stated the Partnership purchased the Property.

represented the seller's equity. The all inclusive note was secured by a third trust deed against the Property.

In 1986, Cal American transferred the Property to the Partnership and was replaced as the general partner of the Partnership by the John Muir Corporation (the "Corporation"), a California corporation. Joyce was the president, secretary, treasurer and sole shareholder of the Corporation. As of 1986, Joyce was the sole limited partner owning 99 percent of the Partnership and the sole shareholder of the Corporation which owned one percent of the Partnership and was its general partner. Fred had no interest in the Partnership as of 1986.

Sometime in 1986, the Partnership sought to refinance the debt on the Property in order to obtain a lower interest rate which would have made the Partnership more profitable as the refinancing was projected to save the Partnership approximately $1 million a year in interest payments. The refinancing required the consent of the Fund as holder of the all inclusive note. As managing partner of the Fund, Traweek agreed to consent to the refinancing by signing a subordination agreement only if he received a personal loan from the Partnership in the amount of $857,336.

In order to fund the loan to Traweek, Joyce transferred personal funds in the amount of $857,336 into an escrow account in the name of the Partnership which then loaned the money to Traweek in the form of a disbursement from the escrow account in exchange for the signed subordination agreement and a promissory note (the "Note") in favor of the Partnership. The Note was secured by an assignment to the Partnership of Traweek's 20 percent interest in the Fund. The Partnership then assigned the Note to Joyce "[a]s security" for the money she advanced and funded to the Partnership.

The assignment was made for the purpose of expediency to avoid the delay of Traweek paying the Partnership and then the Partnership paying Joyce, i.e., as the treasurer of the Partnership's general partner, Joyce would have had to write checks to herself.

Pursuant to the assignment, Traweek made payments on the Note directly to Joyce until June 1987 when he filed for bankruptcy. The Partnership was a creditor in the bankruptcy. Near the end of 1987, Traweek reached an agreement with Security Pacific National Bank ("Security Pacific"), his principal creditor, to liquidate his assets in order to repay Security Pacific. Traweek dismissed his bankruptcy without receiving a discharge of his debts. Traweek resumed making payments to Joyce until mid-1990. By the middle of 1990, Security Pacific had liquidated Traweek's assets, including his 20 percent interest in the Fund, leaving Traweek insolvent, without assets and unable to repay the Note. All of the payments made by Traweek on the Note were applied to interest only.

At no time after the loan to Traweek was Joyce's capital account in the Partnership increased.[3] The limited partnership agreement did not require Joyce to make any additional capital contribution. Similarly, at no time after the Note was assigned to Joyce did the books and records of the Partnership reflect any distribution to Joyce.

In their 1990 joint personal income tax return, appellants deducted as an ordinary loss, business bad debt the loan amount of $857,336. Because the deduction created a net operating loss ("NOL") carryover, the NOL was used on appellants' 1993 joint return. The FTB audited appellants' 1990 California return and made a determination that the alleged bad debt was incurred to protect Joyce's investment in the Partnership and was therefore a (capital loss) nonbusiness bad debt. Based upon that determination, the FTB issued notices of proposed assessment for the years at issue.

Appellants appealed the decision to the State Board of Equalization ("SBE"). The SBE sustained the FTB's determination, finding that the transfer of funds from Joyce to the Partnership was an investment transaction rather than a loan and that because Joyce was a limited partner in a limited partnership, the bad debt had not been acquired by her

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[3] According to the Partnership agreement each partner's capital contribution was set forth in exhibit A, which was attached to the agreement. Exhibit A states the capital contribution of Fred and Joyce was "100" and of Cal-American was "0." It is not clear if that was a dollar amount or a percentage.

while engaged in the trade or business of the Partnership. The SBE also determined that although the debt could be considered a bad business debt in the hands of the Partnership, it was not a bad debt as to Joyce.

Appellants paid the disputed tax and interest for tax years 1990 and 1993 (approximately $142,429) and filed a claim for refund on the grounds that Joyce's advancement of funds to the Partnership was related to the business of the Partnership and that the business of the Partnership must be imputed to Joyce as a limited partner. The claim was denied by the FTB. Appellants then filed the instant refund action.

After a trial on stipulated facts, the court ruled Joyce's advancement of funds was a capital contribution not a loan, the assignment of the Note as security for the advance of funds did not give rise to a business bad debt as to her, Joyce did not loan money directly to Traweek and Joyce was not engaged in the business of the Partnership. The court entered judgment in favor of the FTB.

Appellants filed a timely notice of appeal from the judgment.[4]

DISCUSSION

The instant case was tried to the court on stipulated facts. The application of tax statutes to undisputed facts is reviewed de novo. (*Brown Group Retail, Inc. v. Franchise Tax Bd.* (1996) 44 Cal.App.4th 823, 829.)

I. Capital Contribution

Appellants contend that because the subject loan was made for a valid business purpose, pursuant to Internal Revenue Code section[5] 166, they were entitled to take a

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[4] Appellants failed to include in their appendix a copy of their notice of appeal as required by California Rules of Court, rules 5.1(b) and 5(b).

[5] Unless otherwise noted, all statutory references are to the Internal Revenue Code (found in 26 U.S.C.).

deduction for a bad business loan when the loan became worthless. Respondent contends the money Joyce advanced to the Partnership was a nondeductible capital contribution or a nonbusiness bad debt.

Appellants argue that it is clear from the undisputed evidence looked at as a whole, the subject transaction was intended to be a loan from Joyce to Traweek.[6] (*Myers Building Industries, Ltd. v. Interface Technology, Inc.* (1993) 13 Cal.App.4th 949, 967 ["Several documents concerning the same subject and made part of the same transaction will be construed together even if the documents were not executed contemporaneously."].)

In *Adelson v. United States* (Fed.Cir. 1984) 737 F.2d 1569, the taxpayer, a financial consultant, argued he was entitled to deduct as additions to bad debt reserves, funds advanced by him to his clients to fund growth of his clients' companies. One of the issues addressed by the court was whether the advances made by the taxpayer were bona fide debts.[7] The court reasoned: "Only a 'bona fide debt' qualifies for a deduction under I.R.C. § 166. A 'bona fide debt' is defined as 'a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.' Contributions to capital are specifically excluded from I.R.C. § 166." (Citation omitted.) (*Id.*, at p. 1571.) The court distinguished between a loan and risk capital, "a loan is made upon the reasonable assumption that it will be repaid no matter whether the business venture is successful or not, while capital is put to the risk of the business." (*Ibid.*) The court further noted, "'[t]he real differences [between a debt and a capital contribution] lie in the debt-creating intention of the parties, and the genuineness of repayment prospects in the light of economic realities.'" (*Ibid.*)

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[6] According to appellants, although the subordination agreement, preliminary escrow instructions, promissory note and assignment were not executed at the same time, they were part and parcel of one overall transaction designed to refinance the Property.

[7] In *Adelson*, there was no issue as to whether the taxpayer was engaged in the trade or business of the partnership. (*Adelson v. United States*, *supra*, 737 F.2d at p. 1571.)

The question of whether an advance is debt or equity is "'primarily directed at ascertaining the intent of the parties,'" a determination which is a question of fact which once resolved by the trial court, cannot be overturned unless clearly erroneous. (*Bauer v. C.I.R.* (9th Cir. 1985) 748 F.2d 1365, 1367.) The SBE and the superior court determined the funds advanced to the Partnership were capital contributions.

In *Gilbert v. Commissioner of Internal Revenue* (2d Cir. 1957) 248 F.2d 399, 406, the court noted that numerous cases had denied deductions to taxpayers when advances "were made under such circumstances as to negative any reasonable expectation of repayment." It is apparent that Joyce did not expect repayment by the Partnership. There was no certificate evidencing any indebtedness by the Partnership, no maturity date for repayment by the Partnership, the repayment was to be made by a third party (via the assignment of the Note as security), there was no right to enforce payment from the Partnership, and as a limited partner, Joyce had no right to participate in the management of the Partnership. (See factors discussed in *Hardman v. U.S.* (9th Cir. 1987) 827 F.2d 1409, 1412; see also *Hambuechen v. Commissioner* (1964) 43 T.C. 90, 102 ["[W]here it becomes necessary, for tax purposes, to determine whether an advance by a partner to his partnership was in fact a loan, a determination of this question will be based upon all the facts and circumstances surrounding the transaction."].)

Joyce was the sole limited partner owning 99 percent of the Partnership and the sole shareholder of the Corporation which owned one percent of the Partnership and was its general partner. (Cf. *Adelson v. United States*, *supra*, 737 F.2d at p. 1573 ["In a case in which there is a complete identity of ownership between the creditor and the debtor, there is a far greater likelihood that the purported loan is actually a disguised capital contribution, as this arrangement would permit a 100-percent shareholder to obtain certain tax advantages, such as an ordinary loss under [§ 166] if the debt became worthless, . . ."].)

Appellants assert the substance of taxable transaction and not its form controls. (See e.g. *General Motors Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 783-784 and cases cited therein ["in deciding transaction's tax treatment, court should look to transaction's economic reality"].) According to appellants, the intent was to prearrange for Traweek to repay Joyce directly. However, the reason Traweek was to repay Joyce directly was for the purpose of expediency so she would not have to write checks to herself. The fact Joyce intended to ignore the Partnership does not mean she could do so. If she wanted to loan money to Traweek, she could have done so directly.

Appellants argue the lack of a formal loan agreement between Joyce and Traweek is of no consequence and complain the court focused on only one leg of the transaction -- Joyce's advance of money to the Partnership. That leg was a key component of the transaction. We need not decide if the money Joyce advanced to the Partnership was intended to be a loan or a capital contribution, but note if the advance was a capital contribution, it cannot be claimed as a bad business debt, and, if a loan, the money is owed by the Partnership. Instead, we will address whether Traweek's failure to repay the loan was a bad business debt as to Joyce.

II. Bad Business Debt

California Revenue and Taxation Code, which contains no provisions for how limited partners and limited partnerships are to be taxed, provides in section 17851 that: "Subchapter K of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to partners and partnerships, shall apply, except as otherwise provided."

To deduct a bad business debt, section 166 states:

> "(a) General rule.—
>
> "(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

"....

"(d) Nonbusiness debts.—

"(1) General rule.—In the case of a taxpayer other than a corporation—

"(A) subsection (a) shall not apply to any nonbusiness debt; and

"....

"(2) Nonbusiness debt defined.—For purposes of paragraph (1), the term 'nonbusiness debt' means a debt other than—

"(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

"(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

"In order to establish entitlement to deductions and credits, taxpayers have the burden of proving that they meet the statutory requisites." (*Booker v. Commissioner* (1996) T.C. Memo 1996-261; *Krumpotich v. Franchise Tax Bd.* (1994) 26 Cal.App.4th 1667, 1671 [same].)

Under section 166, in order to claim a deduction for a bad business debt, the taxpayer must establish "(1) that he is engaged in a trade or business, and (2) that the bad debt loss is proximately related to the conduct of that trade or business." (*Harsha v. U. S.* (10th Cir. 1979) 590 F.2d 884, 886; see also *Levin v. United States* (Ct.Cl. 1979) 597 F.2d 760, 764.) Citing *Harsha*, appellants argue the loan to Traweek was made in connection with the Partnership's business. The SBE found Traweek's failure to repay the loan was a bad business debt as to the Partnership. The loss was proximately related to the business of the Partnership as Joyce advanced the funds in order to refinance the Property and increase the profitability of the Partnership by saving on interest payments.

(See *Harsha*, at p. 887.) However, the SBE also found the loan was not a bad business debt as to Joyce because she was not engaged in the business or trade of the Partnership.

Joyce was a limited partner. (See *Gregg v. U.S.* (D.Or. 2000) 186 F.Supp.2d 1123, 1128 ["'[A] limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status.'"]; *Wyler v. Feuer* (1978) 85 Cal.App.3d 392, 402 ["A limited partnership affords a vehicle for capital investment whereby the limited partner restricts his liability to the amount of his investment in return for surrender of any right to manage and control the partnership."].) The Partnership agreement provided the limited partner "shall have no power or authority to manage the partnership business, or transact business on behalf of or in the name of the Partnership, or bind or obligate the Partnership."

"For a taxpayer to be carrying on a trade or business, the 'taxpayer must be involved in the activity with continuity and regularity . . . .'" (*Wood v. Commissioner of Internal Revenue* (2005) 138 Fed.Appx. 168, 172.) Appellants' tax return listed Joyce's occupation as a housewife. Appellants do not claim Joyce was herself engaged in the business of managing the Property; rather their claim is that the business of the Partnership must be imputed to Joyce.

Moreover, appellants claim that as assignee of the Note, Joyce stands in the shoes of the Partnership and can deduct the bad business debt. (*American-LaFrance-Foamite Corporation v. C. I. R.* (2d Cir. 1960) 284 F.2d 723, 724 [In determining whether advances were contributions or loans, "it is said that 'the intention of the parties is a major factor in determining the true nature of the relationship,'" but even though "[t]he 'substance' rather than the 'form' of the transaction has frequently been stressed. In the final analysis, it is from that composite of all the facts that an attempt must be made to create a probably non-existent intent . . . ." (Citations omitted; emphasis deleted.)].) Appellants argue that as assignee, Joyce acquired the right to repayment which created a debtor-creditor relationship between Joyce and Traweek. (*Professional Collection Consultants v. Hanada* (1997) 53 Cal.App.4th 1016, 1018-1019 ["An assignee stands in shoes of the assignor, acquiring all of its rights and liabilities."].)

Citing section 702, appellants claim the character of the loan did not change when it was assigned to Joyce, i.e., it was a business loan from her to Traweek. Section 702(b) provides: "The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

Appellants did not deduct the bad business debt as an item from the Partnership's distributive share but rather it was deducted as an item of personal loss. Even though appellants note that the losses from debts are treated differently from other losses in that the relevant provisions are mutually exclusive (see *Spring City Co. v. Commissioner* (1934) 292 U.S. 182, 189), neither party discusses what the effect would have been if the bad business debt had been deducted by appellants as a partnership loss. (See discussion in Friedman, Cal. Practice Guide: Corporations (The Rutter Group 2006) § 2:89-2:97 ["[P]artnership losses are 'passed through' to the partners, and may be utilized to reduce other taxable income, subject to basis limitations, 'at risk' loss limitations and 'passive activity' loss limitations." (Emphasis deleted.)].)[8]

Appellant insist their right to take a business deduction for bad business debt is recognized by controlling tax law and cite *Harding v. United States* (Ct.Cl. 1953) 113 F.Supp. 461 and *S.E. Maitland Brenhouse v. Commissioner of Internal Revenue* (1961) 37 T.C. 326. In *Harding*, the plaintiff, a broker, approached a broker with another firm and agreed to loan him the money necessary to purchase a seat on the New York stock exchange to handle the business of the plaintiff's partnership. The court reasoned: "Plaintiff's business was a brokerage business carried on through the instrumentality of the brokerage firm of Chas. D. Barney & Company and its successor Smith, Barney & Company. Plaintiff borrowed the money in order to promote the business of this

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[8] In its decision, the SBE stated that if the Partnership had retained the loan rather than distributing it, the subsequent loss would have passed through to appellants as a passive activity loss not as an ordinary business loss.

partnership, and, therefore, his own business, and it would, therefore, seem plain that the loss sustained by plaintiff on account of this bad debt was a loss attributable to the carrying on his business through the instrumentality of the brokerage firm." (*Harding*, at p. 463.) However, the court noted the plaintiff would not be entitled to the deduction for a bad debt if it was "'not attributable to the operation of a trade or business regularly carried on' by him." (*Ibid.*)

In *Maitland*, the petitioner Martin Kornbluth formed a partnership, the business of which was the design and display of point-of-sale displays. Kornbluth was the sales manager of the partnership, and it was his responsibility to promote the product of the business. When there was not enough business, Kornbluth advanced moneys to another company to introduce him to display buyers. Kornbluth never received repayment of the moneys. The court determined the debt was a bad business debt as the only reason for its existence was a proximate relation to the business of Kornbluth's partnership. (*S.E. Maitland Brenhouse v. Commissioner of Internal Revenue*, *supra*, 37 T.C. at p. 330.)

These cases beg the question of whether Joyce's business was the business of the Partnership. Unlike the plaintiffs in *Harding* and *Maitland*, Joyce was not personally in the business of managing property, she was not a general or managing partner, and she did not advance money to the third party, but to the Partnership.

Appellants contend the business of a partnership is imputed to the limited partners. As support, appellants cite *Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284, 1291, in which the court applied section 875, which provides a nonresident alien is considered to be engaged in a trade or business in the United States where a limited partnership of which the person is a member is so engaged. Appellants reason that if a nonresident alien is considered to be engaged in the business of a partnership then a United States citizen should also be considered to be engaged in the trade or business of his or her partnership. However, appellants cite no federal or state statute similar to section 875 providing so.

As further support that because partnerships are pass-through entities, the business of the partnership is imputed to the limited partners for tax purposes, appellants cite *Stanchfield v. Commissioner of Internal Revenue* (1965) T.C. Memo 1965-305 and *Butler v. Commissioner of Internal Revenue* (1961) 36 T.C. 1097. In *Stanchfield*, the tax court noted that even though the trade or business of a corporation was distinct from its stockholders, "we do not believe a similar distinction can be made in the case of a partnership and its partners." However, there was no issue as to whether the taxpayer was engaged in the business of the joint venture (not a partnership).

In *Butler*, the court reasoned: "Whether a taxpayer's activities constitute the carrying on of a trade or business so that bad debts proximately related thereto may be deducted in full is essentially a question of fact, requiring an examination of the particular facts in each case." (*Butler v. Commissioner of Internal Revenue, supra,* 36 T.C. at p. 1106.) Although the court also observed that "[b]y reason of being a partner in a business petitioner was individually engaged in business," (*ibid.*) unlike the instant case, the court noted it had not been urged to make any distinction between ordinary and limited partners. (*Id.*, at p. 1105.)

Citing several treatises, *Whipple v. Commissioner* (1963) 373 U.S. 193, and *United States v. Generes* (1972) 405 U.S. 93, the SBE distinguished *Butler* and concluded that as a limited partner Joyce was more like a shareholder because her rewards did not flow "from personal effort, but from earnings and appreciation" so she did not acquire the debt in question "while engaged in the trade or business of the Partnership." We find the SBE's reasoning persuasive.

None of the cases cited by appellants involved a "loan" by a limited partner, not to the partnership, but to a third party via the instrumentality of the limited partnership. The Note established the loan was made by the Partnership to Traweek; only the Partnership was listed as a creditor in Traweek's bankruptcy. "It is settled that taxpayers must normally accept the tax consequences of the way in which they deliberately choose to cast their transactions." (*Lareau v. U.S.* (Ct.Cl. 1978) 78-2 USTC 86045, 86049.) "Generally, where a taxpayer seeks to impugn his own transaction for his own tax

benefit, the courts will not pay heed except in extraordinary circumstances." (*Id.*, at p. 86051.) "As a general rule, the government may indeed bind a taxpayer to the form in which he has factually cast a transaction. The rule exists because to permit a taxpayer at will to challenge his own forms in favor of what he subsequently asserts to be true 'substance' would encourage post-transactional tax-planning and unwarranted litigation on the part of many taxpayers and raise a monumental administrative burden and substantial problems of proof on the part of the government." (Citations omitted.) (*In re Steen* (9th Cir. 1975) 509 F.2d 1398, 1402, fn. 4; see also *Commissioner v. Nat. Alfalfa Dehydrating* (1974) 417 U.S. 134, 149 ["[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not." (Citations omitted.)].)

Appellants argue that the business of the Partnership should be imputed to Joyce while urging that the Partnership was a pass-through entity. In other words, appellants want to ignore the fact the Partnership loaned the money to Traweek, but take advantage of the Partnership by imputing its business to Joyce. We hold that the assignment of the Note to Joyce did not trump the form used and agree with the SBE and the FTB that the default on the loan was not a bad debt as to Joyce.

DISPOSITION

The judgment is affirmed. Respondent to recover costs on appeal.

NOT TO BE PUBLISHED IN THE OFFICIAL REPORTS

WOODS, J.

We concur:

JOHNSON, Acting P.J. **ZELON, J.**